

**TETHYS PETROLEUM LIMITED**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**for the 6 months ended June 30, 2009**

**Introduction**

This Management's Discussion and Analysis ("MD&A") for Tethys Petroleum Limited ("the Company") is dated August 14, 2009 and should be read in conjunction with the Company's unaudited Interim Consolidated Financial Statements (Interim Consolidated Financial Statements) for the period ended June 30, 2009, which are prepared in accordance with International Financial Reporting Standards (IFRS), as well as the audited Consolidated Financial Statements and the MD&A for the year ended December 31, 2008, which were prepared under US GAAP. *Please refer to Note 23 of the interim consolidated financial statements for reconciliation of US GAAP to IFRS.* The accompanying financial statements of the Company have been prepared by management and approved by the Company's Audit Committee and Board of Directors. Readers should also read the "Forward-Looking Statements" legal advisory contained at the end of this MD&A.

**Operations**

Tethys is an oil and gas exploration and production company focused on projects in Central Asia. Currently the Company has projects in Kazakhstan, Tajikistan and Uzbekistan. In Kazakhstan, the Company's oil and natural gas interests relate to three contract areas, namely the Kyzylai natural gas field and the Akkulka and Kul-Bas exploration blocks, located in three contiguous blocks in an area of Kazakhstan to the west of the Aral Sea, in a geological area known as the North Ustyurt basin. In Tajikistan, the Company's projects are located in the south of the country, in a geologic basin known as the Afghan-Tajik Basin which is the easterly extension of the Amu-Darya Basin which is productive in Uzbekistan and Turkmenistan. In Uzbekistan, the Company operates under a Production Enhancement Contract ("PEC") for the North Urtaulak Oil Field which lies in the Kashkadarya oblast and within the Amu Darya basin.

In Kazakhstan, the Company owns its current interests through a wholly owned Kazakh limited liability partnership named Tethys Aral Gas LLP (TAG), previously named BN Munai LLP. As a result of this ownership, the Company currently has a 100% interest in, and is operator of, a proven shallow gas field (the Kyzylai Field). TAG also has a 100% interest in the surrounding Akkulka Exploration Licence and Contract area (which has proven gas reserves), and a 100% interest in the Kul-Bas Exploration and Production Contract area. These lands are all within the Aktobe Region of western Kazakhstan. An independent reserve report carried out by McDaniel & Associates Consultants Ltd., of Calgary, Alberta, Canada (the "McDaniel Reserve Report") estimated that Tethys had net proved plus probable reserves of 71.4 billion cubic feet (Bcf) (2.03 billion cubic metres (Bcm)) of natural gas in the Kyzylai Field and the Akkulka Block as at December 31, 2008. The Kyzylai Field commenced production on December 19, 2007. Tethys has built a 35 mile (56 km) 325 mm (12.8 inch) diameter export pipeline from the Kyzylai Field gathering station to the main Bukhara-Urals gas trunkline, where a compressor station has been constructed (known as the Booster Compression Station or "BCS") and with gas flowing into the main trunkline which is owned by Intergas Central Asia, a division of the Kazakh state natural gas company KazTransGas. The BCS has recently been upgraded with the addition of two further compressor units to take production from the Akkulka Field.

In Tajikistan the Company through its subsidiary Kulob Petroleum Limited (KPL) is the Contractor under a Production Sharing Contract with the Government of Tajikistan covering the Bokhtar area of the south western region of Tajikistan (Bokhtar PSC). In December 2007 the Company announced that it had signed an agreement to take a partner on these projects in Tajikistan that would have given the Company a 51% operating interest in these projects that includes the Bokhtar PSC. At June 30, 2009 this partnership had not completed and as such the Company currently owns 100% of the operating interest, but discussions are ongoing with the partners as to certain issues that may well result in completion of this agreement.

**Acquisition**

On April 9, 2009, the Company completed the acquisition of Baker Hughes (Cyprus) Limited (BHCL), which holds the entire interest in a production enhancement contract (PEC) dated August 19, 1999, as amended for the North Urtaulak oil field in Uzbekistan. The purchase price for the acquisition was satisfied by the issuance of 15,000,000 Ordinary Shares, restricted from resale for a period of six months (in respect of an aggregate of 7,500,000 Ordinary Shares) and one year (in respect of an aggregate of 7,500,000 Ordinary Shares) from the date of completion of the

acquisition. The North Urtabulak oil field is located in southern Uzbekistan in the northern portion of the Amu-Darya basin. The nearest city is Bukhara, which is approximately 120 km north-west of the field. The field produces from a Jurassic age reef structure at a depth of approximately 2,500 m (8,125 ft). Surface elevation is approximately 320 m (1,040 ft).

## IFRS ACCOUNTING

The Accounting Standards Board (“AcSB”) confirmed in February 2008 that International Financial Reporting Standards (“IFRS”) will be used for Canadian publicly accountable enterprises for financial periods beginning on and after January 1, 2011. As a foreign issuer, Tethys elected early adoption for periods beginning January 1, 2009 and consequently prepared its first interim consolidated financial statements in accordance with IFRS for the three month period ended March 31, 2009. The interim consolidated financial statements for the period ended June 30, 2009 are the Company’s second interim consolidated financial statements prepared under IFRS. For all accounting periods prior to March 31, 2009 the Company prepared its financial statements under generally accepted accounting principles in the United States of America (‘US GAAP’). See *Changes to Accounting Policies on page 23*

Additional information relating to the Company can be found on the SEDAR website at [www.sedar.com](http://www.sedar.com). Readers should also read the “Forward-Looking Statements” legal advisory contained at the end of this MD&A and also the Company’s Annual Information Form (AIF).

## Summary of Quarterly Results

The 2007 comparative figures in the table below have been prepared under US GAAP while the 2008 figures have been restated to comply with IFRS requirements.

	Three months ended							
	US GAAP		IFRS					
	Sept 30 2007	Dec 31 2007	March 31 2008	June 30 2008	Sept 30 2008	Dec 31 2008	March 31 2009	June 30 2009
<b>Financials (\$000’s)</b>								
Revenue	-	194	1,431	1,566	1,485	878	529	2,797
Net loss	(2,969)	(16,372)	(4,611)	(5,023)	(4,905)	(7,645)	(6,016)	(5,593)
Basic and diluted loss (\$) per share	(0.07)	(0.36)	(0.10)	(0.11)	(0.07)	(0.13)	(0.09)	(0.06)
Capital Expenditure	3,845	11,622	3,541	9,565	14,152	15,085	10,237	4,778
Total Assets	85,749	71,656	82,043	124,968	119,326	113,548	108,201	127,577
Total long Term Liabilities	651	1,437	5,960	5,611	5,413	6,084	5,595	5,299
Cash and working capital surplus	37,161	25,773	22,824	56,719	36,598	21,343	7,947	17,351

## The three months ended June 30, 2009 compared to the three months ended June 30, 2008

	Three months ended June 30,		
	2009	2008	% Change
<b>Financials (\$000’s)</b>			
Revenue	2,797	1,566	79
Net Loss	(5,593)	(5,023)	11
Capital Expenditure	4,778	9,565	(51)
Total Assets	127,577	124,968	2
Long Term Liabilities	5,299	5,611	(6)
Cash and working capital surplus	17,351	56,719	(69)

### Highlights

- On June 19, 2009 the Company completed a public offering raising gross proceeds of \$20,000,000 (net proceeds were \$18,019,000 after deduction of the transaction costs).
- The Company acquired BHCL in Uzbekistan which generated revenue of \$1,637,000.
- Because of restrictions further up in the Bukhara-Urals Gas line the Kyzylai gas output was reduced to approximately half of its planned production level with effect from the middle of May. As a result of this reduction in the Kyzylai output the level of revenue generated in Kazakhstan in the three months to June 30, 2009 was less than anticipated at \$1,160,000. This restriction has now been removed.
- The overdue debts of approximately \$1,000,000 reported in the Q1 2009 interim consolidated financial statements were settled in the period.
- A net loss of \$5,593,000 was recorded in the three months to June 30, 2009 compared to a loss of \$5,023,000 for the same period in 2008.
- Capital expenditure of \$4,778,000 was incurred in the three months to June 30, 2009 compared to \$9,565,000 for the same period in 2008.

### Net Loss

A net loss of \$5,593,000 was recorded in the three months to June 30, 2009, compared to \$5,023,000 in the three months to June 30, 2008. The principal differences between the two periods were:

- As a result of the BHCL acquisition additional revenues of \$1,637,000 were generated during the second quarter of 2009.
- Operating costs for Q2 2009 were \$681,000 for Uzbekistan and \$275,000 in Kazakhstan compared to \$196,000 in Kazakhstan for the same period in 2008.
- Depreciation, depletion and amortization (DD&A) in Q2 2009 was \$1,398,000 compared to \$1,249,000 in the same period of 2008. While there was a reduction in the Kazakhstan depreciation as a result of the reduced production in Q2 there was a charge for the Uzbekistan assets in the quarter.
- Stock based compensation costs in Q2 2009 were \$916,000 compared to \$2,084,000 in Q2 2008.
- G & A costs in the three months to June 30, 2009 were made up of \$418,000 for Uzbekistan plus \$3,068,000 elsewhere compared to \$2,982,000 the same period of 2008.

### Capital Expenditure

Capital expenditure in the three months to June 30, 2009 was \$4,778,000 compared to \$9,565,000 in the same period of 2008. Prepayments to contractors decreased from \$595,000 at March 31, 2009 to \$360,000 at June 30, 2009. Capital expenditure for the period focused on:

- Completion of the compressor station in anticipation of Phase 2 gas production from Akkulka.
- Costs incurred in advance of commencement of the deep well in Akkulka (AKD01).
- Processing of seismic data.
- Costs incurred in anticipation of commencement of the new well in Tajikistan (KOM 200).
- Costs relating to taking over well EOL 09 in Tajikistan.

### Revenue

Total revenue realised in Q2 2009 consisted of \$1,160,000 in Kazakhstan and \$1,637,000 in Uzbekistan.

In prior periods Tethys through its Kazak subsidiary TAG was party to a natural gas supply contract (“gas supply contract”) with Kazakhstani Petrochemical Company Chemical LLP. With effect from May 1, 2009 this contract was assigned to Asia Gas NG LLP, who will utilise the gas in the domestic Kazakh market. The agreed price

remains at US\$0.90 per thousand cubic feet (Mcf) (US\$32 per thousand cubic metres (Mcm)) plus 12% VAT. The VAT receipts can be offset against VAT costs incurred on the Kyzylloi project giving an effective price of US\$1.02 per Mcf (US\$ 35.84 per Mcm). The Gas Supply Contract, which has a term until the earlier of December 1, 2012, the date on which all contracts and licences pursuant to which the gas to be delivered under the Gas Supply Contract terminate, or when 850 thousand cubic metres (Mcm) (approximately 30 billion cubic feet (Bcf)) has been delivered, is based on a take-or-pay principle and covers all gas produced from the Kyzylloi Field Licence and Production Contract area up to termination. Total production achieved to June 30, 2009 was 231 Mcm (8 Bcf).

On November 28, 2008 InterGas Central Asia initiated necessary maintenance work on the Bukhara-Urals trunk line to the north of Tethys's tie-in point which resulted in the trunk-line being shut down for a period. Tethys decided to use this time to carry out maintenance on its own compressors and to begin installation of compressors for the Akkulka Phase 2 Development following the arrival on site of both the compressors and the installation engineers. Unfortunately because of extreme weather conditions this process took significantly longer to complete than was anticipated with the result that production did not recommence until March 5, 2009. Additionally from the middle of May 2009 because of restrictions further up in the Bukhara-Urals Gas line the Kyzylloi gas output was temporarily reduced to approximate half of its full production capacity. Full production did not recommence until the beginning of August. This reduction in output resulted in a drop in revenue in the three months to June 30, 2009 of \$400,000.

In January 2009 Tethys' subsidiary Kulob Petroleum Limited, ("KPL") signed a 1-year gas sales contract with OJSC Kulyabgaz to supply gas to the town of Kulob in Southern Tajikistan. The price under the contract was fixed for the period of the contract at 300 Somoni (approximately USD86 per thousand cubic metres ("Mcm") (USD2.44 per thousand cubic feet ("Mcf"))) and the initial contract was to supply up to 65,000 cubic metres (2.3 million cubic feet) of gas per day. Initial limited gas supply commenced and the gas was delivered through a 12 kilometre (7.5 mile) pipeline from the Khoja Sartez Field on which KPL has commenced initial work on existing wells that it has rights to under the Bohktar Production Sharing Contract (the "PSC") signed in June 2008. Delivery of gas under the Tajik Gas Supply Contract was suspended in March 2009 when production from the one producing well in the Khoja Sartez field was halted pending well rehabilitation.

#### **The Production Enhancement Contract in Uzbekistan**

Under the PEC, the Company is a partner and Contractor with two state-owned Uzbek oil companies, JSC Uzneftegazdobycha and JSC Uznefteprodukt (the "Uzbek State Partners"), each part of the Uzbek state oil and gas National Holding Company, Uzbekneftegaz. The work program and budget under the PEC is approved by an operating committee which is jointly run by the Contractor and Uzneftegazdobycha. Under the PEC, the Contractor receives 50% of all incremental production of each individual well it works on for the first three years of production, and the Uzbek State Partners receive 50%. After three years of production from the well, the Contractor receives 20%, and the Uzbek State Partners 80%. Under the PEC, the Company is responsible for all capital investment and carrying out all operations on its wells in the North Urtabulak oil field. The oil produced under the PEC is refined at a local refinery and the Contractor uses jointly appointed marketing agents to sell its share of the refined products for export. The PEC terminates eight years after the date of the first incremental production from the final well drilled or used in the field by the Contractor during the term of the PEC. The Company is carrying out work on additional wells in 2009, which would have the effect of resetting this eight year period each time a well is completed and production obtained. Under the terms of the PEC the Company has no rights to the land or the reserves.

#### Royalties

In Kazakhstan in 2009 royalties were replaced by Mineral Extraction Tax (MET). MET on domestic sales is anticipated to be 0.5% of revenue or 10.0% of revenue on export sales. Kyzylloi sales are currently domestic and as such the MET at 0.5% will compare favourably with the previous royalty of 2.0%.

#### Operating costs

Despite the reduction in gas production output in Kazakhstan the operating costs were comparable to those in the previous three months as most costs are fixed. Operating costs in Uzbekistan at \$681,000 and \$275,000 in Kazakhstan.

### General and Administration Expenses

Excluding the general and administrative expenses of \$418,000 incurred in Uzbekistan the total G & A expenses incurred elsewhere for the three months to June 30, 2009 were \$3,068,000 compared to \$2,982,000 in the same period in 2008. Both Q2 in 2008 and Q2 in 2009 included costs involved in fund raising. Additional professional fees were incurred as a result of the adoption of IFRS in Q1 2009.

### Stock based compensation

For the three months ended June 30, 2009, there was \$916,000 (2008 – \$2,084,000) of pre-tax compensation expense for options granted under the 2007 Long Term Stock Incentive Plan. As of June 30, 2009, there was \$580,000 of total unrecognized compensation expense related to unvested stock options granted under the plan. The Company expects to recognize the expense over a weighted-average period of 0.97 years.

### Foreign Exchange loss

The exchange loss in the three months to June 30, 2009 was \$689,000 compared to \$162,000 in the same period of 2008.

### Depletion, Depreciation and Accretion (DD&A)

The total DD&A charge for Q2 2009 was \$1,398,000 compared to \$1,249,000 in Q2 2008. Because of the enforced reduction in the Kyzylloi production between mid-May and June 30, 2009 the Kazak O&G depreciation for Q2 2009 was reduced but this was compensated by the Uzbekistan depreciation charge.

### Interest

In May 2009 the Company entered into a short term loan of \$2,500,000 at an interest rate of 12% that was repaid upon the successful completion of the fund raising on June 19, 2009. Interest paid was the minimum fixed amount of \$75,000.

In Q2 2009 the Company earned \$19,000 in interest on its own funds compared to \$257,000 in Q2 2008 reflecting both the significant reduction in interest rates on offer in 2009 and the reduced cash balances held by the company.

Finance charges consisted of interest charges relating to the Rig Telesto loan and short term loan, finance charges relating to the short term loan and the amortization of the fair value of the warrants issued in connection with the rig financing.

### Taxes

There is no current period income tax charge (2008 – \$Nil).

Tethys is domiciled in the Cayman Islands which has no company income tax.

At June 30, 2009, the Company's Kazakhstan based subsidiary Tethys Aral Gas LLP had net operating loss carry forwards ("NOLs") for income tax purposes of approximately \$4,710,000 (2008 – \$4,393,500). If the NOLs are not utilized to reduce taxable income in future periods, they will expire in various amounts from 2012 through 2016. No deferred tax asset has been recognised due to the unpredictability of future profits streams.

At December 31, 2008 the Company's subsidiary Baker Hughes (Cyprus) Limited (BHCL) had NOLs for income tax purposes of approximately \$2,214,687. Future profits will be subject to a 16% tax charge in Uzbekistan after utilization of the available losses. As BHCL is domiciled in Cyprus, in certain circumstances interest income may be subject to defense contributions at a rate of 10%. In such cases, 50% of the same interest income will be exempt from corporation tax, thus having an effective tax rate burden of approximately 15%.

***The six months ended June 30, 2009 compared to the six months ended June 30, 2008***

The 2008 figures have been restated to comply with IFRS requirements.

	<b>Six months ended June 30,</b>		<b>% Change</b>
	<b>2009</b>	<b>2008</b>	
<b>Financials</b> (\$000's)			
Revenue	3,326	2,997	11
Net Loss	(11,609)	(9,634)	20
Capital Expenditure	15,015	13,106	15
Total Assets	127,577	113,548	2
Long Term Liabilities	5,299	5,611	(6)
Cash and working capital surplus	17,351	56,719	(69)

**Highlights**

- On June 19, 2009 the Completed a public offering raising gross proceeds of \$20,000,000. (net proceeds to the Company were \$18,019,000 after deduction of transaction fees).
- The Company acquired BHCL in Uzbekistan which generated revenue of \$1,637,000.
- Due to a combination of the Kyzylai production being shut down in January and February 2009 as a result to maintenance work on compressors and the reduction to approximate half of full production capacity because of restrictions further up in the Bukhara-Urals Gas pipeline with effect from the middle of May, the revenue generated in Kazakhstan in the six months to June 30, 2009 was considerably less than anticipated at \$1,653,000. Approximately some \$37,000 was generated in Tajikistan in the first quarter of the year.
- The overdue debts of approximately \$1,000,000 dating back to November and December 2008 were settled in the period.
- A net loss of \$11,609,000 was recorded in the six months to June 30, 2009 compared to a loss of \$9,634,000 for the same period in 2008.
- Capital expenditure of \$15,015,000 was incurred in the six months to June 30, 2009 compared to \$13,106,000 for the same period in 2008.

**Net Loss**

A net loss of \$11,609,000 was recorded in the six months to June 30, 2009, compared to \$9,634,000 in the six months to June 30, 2008. The principal differences between the two periods were:

- Revenue generated in the six months to 2009 was \$3,326,000 compared to \$2,997,000 in the equivalent period in 2008.
- Operating costs for the six months to 2009 were \$1,241,000 compared to \$263,000 for the same period in 2008 primarily because of the inclusion of the new Uzbekistan operation.
- Depreciation, depletion and amortization (DD&A) in Q1 2009 was \$1,915,000 compared to \$2,354,000 in the same period of 2008 due to the reduction in production in Kazakhstan.

- Stock based compensation costs in the six months to June 30, 2009 were 1,620,000 compared to \$2,925,000 in same period in 2008.
- Primarily as a result of the fall of the Kazakhstan Tenge against the USD and the volatility of the Canadian dollar against the US dollar there was an exchange loss in the six months to June 30, 2009 of \$2,483,000 compared to a loss of \$138,000 in the same period of 2008.
- G & A expenses incurred in the six months to June 30, 2009 were \$6,469,000, including \$418,000 in Uzbekistan, compared to \$6,190,000 for the same period in 2008.

### Capital Expenditure

Capital expenditure in the six months to June 30, 2009 was \$15,015,000 compared to \$13,106,000 in the same period of 2008. Prepayments to contractors decreased from \$1,514,000 at December 31, 2008 to \$360,000 at June 30, 2009. The major items of expenditure were:

- Seismic costs in Kul-Bas \$250,000
- Progress payment on ZJ30 rig \$1,872,000
- Coiled tubing unit plus other rig ancillary equipment \$810,000
- Akkulka deep well \$1,100,000
- Phase 2 compressor station \$840,000
- Seismic exploration in Tajikistan \$5,000,000
- Well rehabilitation and workovers in Tajikistan \$930,000
- East Alimtai well in Tajikistan \$250,000
- New Komsomolsk well in Tajikistan \$1,000,000

### Revenue

Total revenue realised in the six months to June 30, 2009 including \$1,637,000 from Uzbekistan was \$3,326,000 compared to \$2,997,000 in the same period of 2008.

In prior periods Tethys through its Kazak subsidiary TAG was party to a natural gas supply contract (“gas supply contract”) with Kazakhstani Petrochemical Company Chemical LLP. With effect from May 1, 2009 this contract was assigned to Asia Gas NG LLP, who will utilise the gas in the domestic Kazakh market. The agreed price remains at US\$0.90 per thousand cubic feet (Mcf) (US\$32 per thousand cubic metres (Mcm)) plus 12% VAT. The VAT receipts can be offset against VAT costs incurred on the Kyzylloi project giving an effective price of US\$1.02 per Mcf (US\$ 36.84 per Mcm). The Gas Supply Contract, which has a term until the earlier of December 1, 2012, the date on which all contracts and licences pursuant to which the gas to be delivered under the Gas Supply Contract terminate, or when 850 thousand cubic metres (Mcm) (approximately 30 billion cubic feet (Bcf)) has been delivered, is based on a take-or-pay principle and covers all gas produced from the Kyzylloi Field Licence and Production Contract area up to termination. Total production achieved to June 30, 2009 was 231 Mcm (8 Bcf).

On November 28, 2008 InterGas Central Asia initiated necessary maintenance work on the Bukhara-Urals trunk line to the north of Tethys's tie-in point which resulted in the trunk-line being shut down for a period. Tethys decided to use this time to carry out maintenance on its own compressors at the BCS and to begin installation of compressors for the Akkulka Phase 2 Development following the arrival on site of both the compressors and the installation engineers. Unfortunately because of extreme weather conditions this process took significantly longer to complete than was anticipated with the result that production did not recommence until March 5, 2009. Then from the middle of May because of restrictions further up in the Bukhara-Urals Gas line the Kyzylloi gas output was temporarily reduced to approximate half of its full production capacity. Full production did not recommence until the beginning of August. The combined impact of the shut down in Q1 and the reduced output in Q2 resulted in a drop in revenue in the region of \$1,400,000.

In January 2009 Tethys' subsidiary Kulob Petroleum Limited, ("KPL") signed a 1-year gas sales contract with OJSC Kulyabgaz to supply gas to the town of Kulob in Southern Tajikistan. The price under the contract was fixed for the period of the contract at 300 Somoni (approximately USD86 per thousand cubic metres ("Mcm") (USD2.44 per thousand cubic feet ("Mcf")) and the initial contract was to supply up to 65,000 cubic metres (2.3 million cubic feet) of gas per day. Initial limited gas supply commenced and the gas was delivered through a 12 kilometre (7.5 mile) pipeline from the Khoja Sartez Field on which KPL has commenced initial work on existing wells that it has rights to under the Bohktar Production Sharing Contract (the "PSC") signed in June 2008. Delivery of gas under the Tajik Gas Supply Contract was suspended in March 2009 when production from the one producing well in the Khoja Sartez field was halted pending well rehabilitation.

#### **The Production Enhancement Contract in Uzbekistan**

Under the PEC, the Company is a partner and Contractor with two state-owned Uzbek oil companies, JSC Uzneftegazdobycha and JSC Uznefteprodukt (the "Uzbek State Partners"), each part of the Uzbek state oil and gas National Holding Company, Uzbekneftegaz. The work program and budget under the PEC is approved by an operating committee which is jointly run by the Contractor and Uzneftegazdobycha. Under the PEC, the Contractor receives 50% of all incremental production of each individual well it works on for the first three years of production, and the Uzbek State Partners receive 50%. After three years of production from the well, the Contractor receives 20%, and the Uzbek State Partners 80%. Under the PEC, the Company is responsible for all capital investment and carrying out all operations on its wells in the North Urtabulak oil field. The oil produced under the PEC is refined at a local refinery and the Contractor uses jointly appointed marketing agents to sell its share of the refined products for export. The PEC terminates eight years after the date of the first incremental production from the final well drilled or used in the field by the Contractor during the term of the PEC. The Company is carrying out work on additional wells in 2009, which would have the effect of resetting this eight year period each time a well is completed and production obtained. Under the terms of the PEC the Company has no rights to the land or the reserves.

#### Royalties

In Kazakhstan in 2009 royalties were replaced by Mineral Extraction Tax (MET). MET on domestic sales is anticipated to be 0.5% of revenue or 10.0% of revenue on export sales. KyzylOI sales are currently domestic and as such the MET at 0.5% will compare favourably with the previous royalty of 2.0%.

#### Operating costs

In Kazakhstan despite the reduction in production in the first quarter as a result of the maintenance work on the compressors there was no significant reduction in the operating costs. The labour force had to be maintained and was used on the monitoring of wells every few days plus the turning over the existing compressors every few days to prevent them from being damaged in the cold weather. Some costs are also fixed by well and need to be paid whether or not there is production. It was a similar story in the second quarter where despite the fact that the output was reduced the level of operating costs continued at the standard level. Total costs for the six months to June 30, 2009 were \$559,000.

In Uzbekistan where the product is oil, as opposed to gas in Kazakhstan, the operating costs incurred were \$681,000 for the three months to June 30, 2006.

#### General and Administrative Expenses

Excluding the general and administrative expenses of \$418,000 incurred in Uzbekistan the total G & A expenses incurred for the six months to June 2009 were \$6,051,000 compared to \$6,190,000 in the same period in 2008. The savings in would have been greater but for the costs incurred in switching from US GAAP based accounting to IFRS. The costs incurred in Uzbekistan included the setting up of a Tethys Representative office in the country together with a number of one off expenses associated with the taking over of a new project.

### Stock based compensation

For the six months ended June 30, 2009, there was \$1,620,000 (2008 – \$2,925,000) of pre-tax compensation expense for options granted under the 2007 Long Term Stock Incentive Plan. As of June 30, 2009, there was \$580,000 of total unrecognized compensation expense related to unvested stock options granted under the plan. The Company expects to recognize the expense over a weighted-average period of 0.97 years.

### Foreign Exchange loss

Following the Kazakhstan central bank's decision to cease supporting the Tenge against the USD the exchange rate dropped from a figure around 120 to 150 to each USD. As a result of this change the Kazakhstan operations incurred an exchange loss of \$1,631,000 which was the principal factor in the Company's total exchange loss of \$2,483,000 (2008 - \$138,000).

### Depletion, Depreciation and Accretion (DD&A)

The total DD&A charge for the six months to June 30, 2009 was \$1,915,000 compared to \$2,354,000 in the same period of 2008. The primary explanation of the reduction is that the KyzylOI Oil and Gas Property and Equipment (O&G) costs are depleted on a unit of production basis and because of the production shut down in January and February 2009 and the enforced reduction in production between mid-May and June 30, 2009 production was significantly lower than in the same period in 2008 resulting in a lower depreciation charge. The reduction was partly offset by the Uzbekistan depreciation charge incurred in Q2.

### Interest

In May 2009 the Company entered into a short term loan of \$2,500,000 at an interest rate of 12% that was repaid upon the successful completion of the fund raising on June 19, 2009. Interest paid was the minimum fixed amount of \$75,000.

In the six months to June 30, 2009 the Company earned \$49,000 in interest on its own funds compared to \$424,000 in the same period of 2008 reflecting a combination of the significant reduction in interest rates in that period plus the reduced level of funds held by the Company.

Finance charges consisted of interest charges relating to the Rig Telesto loan and short term loan, finance charges relating to the short term loan and the amortization of the fair value of the warrants issued in connection with the rig financing.

### Taxes

There is no current period income tax charge (2008 – nil).

Tethys is domiciled in the Cayman Islands which has no company income tax.

At June 30, 2009, the Company's Kazakhstan based subsidiary Tethys Aral Gas LLP had net operating loss carry forwards ("NOLs") for income tax purposes of approximately \$4,710,000 (2008 – \$4,393,500). If the NOLs are not utilized to reduce taxable income in future periods, they will expire in various amounts from 2012 through 2016. No deferred tax asset has been recognised due to the unpredictability of future profits streams.

At December 31, 2008 the Company's subsidiary Bake Hughes (Cyprus) Limited (BHCL) had NOLs for income tax purposes of approximately \$2,214,687. Future profits will be subject to a 16% tax charge in Uzbekistan after utilization of the available losses. As BHCL is domiciled in Cyprus, in certain circumstances interest income may be subject to defense contributions at a rate of 10%. In such cases, 50% of the same interest income will be exempt from corporation tax, thus having an effective tax rate burden of approximately 15%.

## Financial position

The following table outlines significant movements in the consolidated balance sheets from December 31, 2008 to June 30, 2009:

	June 30, 2008	Dec 31, 2008	Movement	Movement Details
Intangible assets	23,837	11,688	12,149	Purchase of PEC in Uzbekistan plus seismic expenditure, expenditure on new well, takeover of existing well and workovers in Tajikistan.
Property, plant and equipment	75,043	69,839	5,204	Completion of Phase 2 compressor station and initial expenditure on Akkulka deep well in Kazakhstan plus purchase of coiled tubing unit.
Non-current other receivables	4,284	6,357	(2,073)	Reduction in VAT balance due to exchange movement plus completion of stages of compressor station and Akkulka drilling resulting in transfer from contractor prepayments to property , plant and equipment.
Current trade and other receivables	2,800	2,664	136	Clearance of old 2008 debts plus the addition of the Uxbekistan invoiced sales in June.
Cash and cash equivalents	20,549	22,200	(1,651)	See cash flow statement
Share capital	167,318	145,237	22,081	Public offering in June, the acquisition of BHCL for shares and the issue of shares to part purchase a coiled tubing unit.
Other reserves	26,767	25,147	1,620	Stock based compensation
Accumulated deficit	(78,263)	(66,654)	(11,609)	Loss incurred in six months to June 30, 2009
Non-current financial liabilities	4,638	5,096	(458)	Capital repayments on Telesto loan plus part of Tykhe loan moving to current liabilities.
Borrowings	1,149	853	296	Impact of part of capital of loan on the Tykhe rig now due in less that twelve months.
Warrants	629	146	483	Movement in warrant liability following issue of warrants in connection with short term loan.
Trade and other payables	4,678	2,735	1,943	The inclusion of the Uzbekistan subsidiary's figures.

**Recent acquisition**

On April 9, 2009 the Company completed the acquisition of BHCL which held the entire interest in the Production Enhancement Contract ("PEC") for the North Urtabulak Oil Field in Uzbekistan.

The consideration for the purchase of this project was 15 million ordinary shares in Tethys restricted from resale for periods up to one year from completion. With immediate effect Tethys took over the running of the business of the Contractor and began working to increase further oil production from the North Urtabulak field. Work is underway on further production enhancement both through workovers on existing wells, improvement of beam pumps etc. In addition reservoir data is being collected and a full field reservoir simulation model is being built which will then be used to optimise the development of the field potentially including the installation of a dedicated gas lift system. Tethys is also considering other development activities including enhancing gas supply for gas lift, further development well drilling, radial drilling and the potential of working on other nearby fields referenced in the PEC. The oil produced under the PEC is refined at a local refinery and the Contractor uses its own marketing agents to sell its share of the refined products at market prices.

**Liquidity and Capital Resources**

As at June 30, 2009 the Company had a working capital surplus, including cash, of \$17,351,000 while at June 30, 2008 the working capital surplus was \$56,719,000.

***Liquidity Risk***

Since inception, the Company has incurred significant losses from operations and negative cash flows from operating activities, and has an accumulated deficit at June 30, 2009. Also the Company has both short-term and longer term contractual commitments that will necessitate cash outflows. The ability of the Company to successfully carry out its business plan is primarily dependent upon its ability not only to maintain the current level of gas production but also to achieve further production of commercial oil and gas and to control the costs of operating and capital expenditures. While these factors create doubt about the Company's ability to continue as a going concern, as discussed in Note 2 to the Interim Consolidated Financial Statements to June 30, 2009, management is confident of achieving the Company's short term plans.

To help it achieve its immediate objectives on June 19, 2009 the Company completed a public offering having placed 51,680,000 shares at a price of US\$0.387 raising US\$ 20,000,000 (gross), net proceeds to the Company were \$18,019,000 after deduction of transaction costs. *Plans for these funds are set out in the "Use of Funds" below.* The Ordinary Shares are listed on the Toronto Stock Exchange.

***Credit Risk***

In the financial statements to March 31, 2009 it was reported that the Company had overdue debts of approximately \$1,000,000 but that the debtor had agreed to clear all of the debt in the coming months. The Company can report that as at June 30, 2009 these debts had been cleared in full.

At June 30, 2009 the debt relating to the May gas sales in Kazakhstan was outstanding but this was settled in July.

***Capital Management***

The Company's objectives when managing capital is to maintain adequate financial flexibility to preserve its ability to meet financial obligations, both current and long term. The capital structure of the Company is managed and adjusted to reflect changes in economic conditions.

The Company funds its expenditures on commitments from existing cash and cash equivalent balances, primarily received from issuances of shareholders equity, as per the public offering completed on June 19, 2009. In 2008 the Company also entered into long term debt agreements to finance the purchase of two drilling rigs. These loans are not subject to any externally imposed capital requirements. In May 2009 the Company entered into a short term loan of \$2,500,000 at an interest rate of 12% that was repaid upon the successful completion of the fund raising on June 19, 2009.

The Company is engaged in acquiring properties and exploring for crude oil and natural gas but it does not as yet have sufficient revenue generating activities to fund all of the Company's commitments. The Company is therefore required to fund a significant portion of its commitments from existing cash and cash equivalent balances or seek additional financing through debt issuances or equity markets.

Financing decisions are made by Management and the Board of Directors based on forecasts of the expected timing and level of capital and operating expenditure required to meet the Company's commitments and development plan. Factors considered when determining whether to issue new debt or to seek equity financing include the amount of financing required, the availability of financial resources, the terms on which the financing is available and in consideration of the balance between shareholder value creation and prudent financial risk management.

Debt levels are monitored by using the non-GAAP financial metric of Net Debt to Capitalization. Net Debt is calculated as the sum of long term debt balances (including the current portion) less the balance of cash and cash equivalents. There was no Net Debt at June 30, 2009 as the cash and cash equivalents exceeded the total of long term loans.

#### ***Cash Generation***

On March 5, 2009 the Company announced that Kyzylloi was now producing from eight wells, an increase of two wells from 2008 production. The revenue generated from this level of production would be in excess of \$500,000 per month. Then from the middle of May because of restrictions further up in the Bukhara-Urals Gas line the Kyzylloi gas output was temporarily reduced to approximate half of its full production capacity. Full production did not recommence until the beginning of August.

With the benefit of these additional wells and the commencement of Phase 2 gas production on Akkulka, which is now anticipated at the end of Q3 2009, there should be a significant increase the daily production. The Phase 2 gas price has yet to be fixed and there has been considerable uncertainty over gas prices in Central Asia in recent months. In the coming months if the Company is unable to negotiate a satisfactory long term sales price it will look to enter into a short term contract for the initial production of Phase 2 gas with a view to negotiating a better price in 2010. Achievement of a satisfactory price on the Phase 2 gas production, along with the existing Kyzylloi revenue, would put the Company's Kazakhstan operations in a position where it would be generating funds surplus to what was required to satisfy the minimum work programme and both the Company's operating and administrative costs. If however Akkulka gas production is delayed then the Company would need to either source further funding or to scale back on its costs.

On January 11, 2009 the Company signed a one year sales contract to supply up to 65 Mcm of gas per day to the town of Kulob in Tajikistan. The contract price was fixed at 300 Somoni (approximately US\$86) per Mcm and was not adjusted for exchange rate fluctuations. Delivery of gas under the Tajik Gas Supply Contract was suspended in March 2009 when production from the one producing well in the Khoja Sartz field was halted pending well rehabilitation.

The Company is optimistic that it will soon see the benefits of its recent acquisition of the Production Enhancement Contract ("PEC") for the North Urtabulak Oil Field in Uzbekistan in terms of a positive cash flow. Under the terms of the PEC, the Company has no expenditure commitments to be fulfilled during the 2009 financial year with respect to the PEC. However, the Company currently intends to expend funds totalling approximately \$500,000 with respect to operations to be carried out in Uzbekistan during 2009, which will primarily involve workovers on existing wells to boost the output and increase sales revenue.

### *Use of Funds*

**Set out below is a comparison of the actual use of funds to date and remaining to be expended against what was projected in the prospectus dated June 18, 2007.**

The primary differences were in relation to:

- The planned Aral Vostochniy acquisition in Kazakhstan where the deal did not proceed because the vendor did not believe that it could meet its obligations.
- No suitable property with proven reserves had been identified for acquisition although the Company continues to look for suitable opportunities.
- There was some overspend on the shallow drilling as the result of discovery of further gas and inclusion of additional pipeline and tie-in costs for gas development.
- In Q3 of 2007 the Company placed an order for a drilling rig.
- Expenditure on the Alimtai well is now expected to be less than originally anticipated.

**It should be noted that following a detailed review of capital expenditure it was noted that some \$7,700,000 of incurred expenditure in Kazakhstan that in prior MD&A's were matched to the June 18, 2007 Prospectus should have more correctly been matched to the June 19, 2008 Prospectus. This has been remedied in the tables below.**

	<b>Per Jun18, 2007 Prospectus</b>	<b>Incurred to Jun 30, 2009</b>	<b>Planned in 2009</b>
<i>Kazakhstan</i>			
Shallow drilling plan, compressors for Phase 2, exploration well, acquisition opportunities, Aral Vostochniy and well workovers.	33,000	25,807	1,100
<i>Tajikistan</i>			
Seismic surveys, well rehabilitation and Alimtai exploration well	7,500	3,500	400
Repayment of short term loan	5,000	5,000	
Working capital	500	1,650	
	<b>46,000</b>	<b>35,957</b>	<b>1,500</b>

**Set out below is a comparison of the actual use of funds to date and remaining to be expended against what was projected in the prospectus dated June 19, 2008.**

The primary differences were in relation to:

- The Company ordered a second drilling rig, primarily for use in Tajikistan
- Further drilling and related equipment was purchased for use on the shallow drilling and production programme in Kazakhstan and in Tajikistan.
- Work has not yet commenced on the West Kul-Bas deep well.
- Unplanned expenditure on a supply and storage base at Bozoi, Kazakhstan, and additional capital spares
- Although new projects have been considered none has yet been considered suitable.

	<b>Per June 19, 2008 Prospectus</b>	<b>Incurred to Jun 30, 2009</b>	<b>Planned in 2009</b>
<i>Kazakhstan</i>			
Shallow Wells and Tie-Ins, deep well, additional seismic and infrastructure	28,100	12,192	100
<i>Tajikistan</i>			
Horizontal drilling, seismic, deepening potential gas exploration well plus infrastructure	8,415	7,760	375
Drilling rigs plus ancillary equipment	5,000	15,629	580
New Projects	3,500	500	
Working Capital and General Corporate Purposes	1,385	2,500	
	46,400	38,581	1,055

**Set out below are details of the planned use of funds to as detailed in the prospectus dated June 11, 2009.**

<i>Tajikistan</i>	
East Komsomolsk – Drill Directional Gas Appraisal Well KOM200-Phase 1	3,500
Infrastructure - Komsomolsk Gas Processing Plant - Phase 1	2,000
East Komsomolsk – Drill Directional Gas Development Well KOM201-Phase 2	3,500
Additional Seismic on Bokhtar PSC	3,660
<i>Uzbekistan</i>	
North Urtabulak Gas Lift Compression System	1,190
North Urtabulak New Well	<u>4,000</u>
Total	17,850,

#### **Capital Expenditure - Contractual Commitments**

There are items in the previous schedules that refer to planned expenditure, which are not mandated by contractual commitments but as at June 30, 2009 the Company's contractual commitments in terms of capital expenditure were as follows:

Kazakhstan minimum work programmes remaining in 2009	\$ 1,100,000
Drilling rigs plus ancillary equipment	<u>\$ 580,000</u>
	\$ 1,680,000

### Contractual obligations and liabilities as at June 30, 2009

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 years
Long term debt*	\$8,258,726	\$1,808,215	\$6,450,511	-	-
Operating leases	\$752,975	\$582,579	\$170,396	-	-
Purchase obligations	\$1,680,000	\$1,680,000	-	-	-
Other long term obligations **	\$864,900	\$173,000	\$345,950	\$345,950	-
Total contractual obligations	\$11,556,601	\$4,243,794	\$6,996,857	\$345,950	-

Operating leases consist primarily of leases for offices

\*These long term debt figures differ from those on the interim consolidated financial statements as these figures include interest as it falls due.

\*\* Under the terms of Kyzylol Field Licence and Production Contract, historic costs totaling \$1,211,000 are payable in equal portions of \$43,244 on a quarterly basis to the Kazakhstan government from the third year of production. Nine quarterly payments had been paid to June 30, 2009, totaling \$389,196 leaving an outstanding balance of \$821,804. The quarterly payments are due to continue until March 2014.

### Future growth

The Company believes that when Phase 2 gas from Akkulka comes on stream then with the Kyzylol production and the PEC in Uzbekistan it will meet its minimum work programme and operating and G&A costs. However in order not only to maintain the Company's current capacity but to meet the Company's planned growth objectives, which include funding planned development activities, the Company would require additional capital. Possible sources of funding include an issue of new shares. The Company is aware, particularly in the current market conditions, that there can be no assurances that the equity or debt financing would be available when required or available on terms that is acceptable to the Company and its shareholders. The inability of the Company to access sufficient capital for its growth objectives would impact on the Company's preferred planned growth targets.

While the Company acknowledges that current market conditions are undoubtedly more challenging than in the same period in 2008 it believes that there does remain fund raising opportunities that it could pursue to fund growth objectives which the Company believes could add additional cash flow.

The Company is actively seeking partners in certain projects, preferably strategic partners who may bring capital into specific projects, or purchase significant interests in existing projects and assist the Company in building its business in Central Asia. Farm outs and possible asset sales are also being considered as part of an overall strategy to balance risk and optimize the Company's portfolio in order to bring available capital to bear on the most significant projects. No agreements have been entered into as at the date of this MD&A.

### Stockholder Equity

As at August 14, 2009 the Company had authorized share capital of 700,000,000 Ordinary Shares of which 134,554,769 had been issued and 50,000,000 preference shares of which none had yet been issued.

As at August 14, 2009 a total of 21,141,956 (December 31, 2008 – 18,311,596) ordinary shares are reserved under the Company's Long Term Stock Incentive Plan and Warrants granted by the Company. Details of the options and warrants are given in note 7 to the Interim Consolidated Financial Statements for the period ended June 30, 2009.

At the AGM held on May 15, 2009 a resolution was passed whereby the number of shares which are reserved for issuance under the Stock Incentive Plan was altered to 12% of the number of Ordinary Shares outstanding at the time of the grant of options rather than the fixed figure of 7,511,760 shares.

## **ENVIRONMENTAL**

The Company's operations are subject to environmental regulations in the jurisdictions in which it operates and the Company carries out its activities and operations in material compliance with all relevant and applicable environmental regulations and pursuant to best industry practices. In Kazakhstan, quarterly reports are required to be submitted by the Company to the Shalkar (Bozoi) Tax Committee. Payments made by the Company to date have been very small. The Company is also required to prepare reports on any pollution of air, toxic waste and current expenses on environmental protection which have been made by the Company and which are submitted to the appropriate Kazakh authorities. Reports are submitted on semi-annual basis for information purposes and no payments are applicable.

Under the Bokhtar PSC in Tajikistan, any Development Plan shall also include an abandonment and site restoration programme together with a funding procedure for such programme. All funds collected pursuant to the funding procedure shall be allocated to site restoration and abandonment and will be placed in a special interest bearing account by KPL which shall be held in the joint names of the State and the KPL or their respective nominees, or its designee. KPL's responsibilities for environmental degradation, site restoration and well abandonment obligations, and any other actual contingent and potential activity associated with the environmental status of the Development Area shall be limited to the obligation to place the necessary funds in the approved account. In addition any relinquished areas must be brought into the same condition as they were prior to their transfer to KPL (soil fertility condition, quality of the ground and environment). All expenditures incurred in abandonment and site restoration are cost recoverable. An independent environmental base line study has been carried out on the Beshtentak oilfield.

Within the PEC in Uzbekistan in the event that the Company advises the Operating Committee that it no longer intends to perform any Operating Services on a well then it is required to plug and abandon such well at its own expense or the state gas company shall immediately assume responsibility for such well. In the latter such event the Company shall have no responsibility with regard to plugging and abandoning the well. While operating the well the Company is required to observe all environmental laws of the Republic of Uzbekistan.

At present, the Company believes that it meets all applicable environmental standards and regulations, in all material respects, and has included appropriate amounts in its capital expenditure budget to continue to meet its environmental obligations.

## **OUTLOOK**

In both of the Company's MD&As for the year ended December 31, 2008 and the quarter ended March 31, 2009 it was stated that Management had reviewed the impact of the recent significant changes in the world economic situation, including the significant decline in energy prices and the decline in the market price for the Company's shares, on its current and planned projects and had no plans to curtail any project that had commenced in the course of 2008 or that were included in the commitment capital expenditure listings above, following this assessment. This remains the Company's position at the end of Q2 2009. As also previously stated uncommitted capital expenditure is constantly under review and as a result some growth plans previously considered have been put on hold until such time as the position of the markets becomes clearer particularly with regard to future gas pricing, production revenues and fundraising opportunities that may be available to the Company. Following the fund raising completed on June 19, 2009 the focus of the short-term capital expenditure programs remains on both meeting the expenditure plans set out in the short form prospectus issued on June 11, 2009 and on development and production enhancement projects that will enhance short to medium term cash flow.

In Kazakhstan, the Company's current plans are limited to satisfying the 2009 Minimum Work Programme for each of the three contracts including the drilling of a deep well on the Akkulka contract. As at the date of this report this drilling has exceeded a depth of 2,500 metres.

In Tajikistan, the Company has initiated its exploration work with the commissioning of an extensive seismic survey to construct field reservoir models and consider horizontal and inclined drilling, field pressure support and similar techniques to increase production of oil and gas, and to look at cost effective approaches to deepening existing wells to test exploration targets. The Company has taken over responsibility for a partly drilled well in East Alimtai and at the beginning of August commenced the drilling of a well in the Komsomolsk field.

As stated above in Uzbekistan work is already underway on further production enhancement both through workovers on existing wells and improvement of beam pumps. In addition the installation of a dedicated gas lift system is being considered in the near future which it is believed would significantly increase the incremental oil production. Tethys is also considering other development activities including further development well drilling and the potential of working on other nearby fields referenced in the PEC but this is subject to obtaining appropriate approval which is not guaranteed.

### **Sensitivities**

The price of gas sales from gas produced from the Kyzylai gas field under the Gas Supply Contract is fixed in US dollars until December 1, 2012 and consequently there is no sensitivity to currency movements or market movements in the gas price. The price of Phase 2 gas sales from gas produced from the Akkulka Block has yet to be agreed and therefore could be sensitive to movements in the market price of gas.

The sales revenue in Uzbekistan is sensitive to fluctuations in the price of oil. At current production levels of 950 bbpd the movement of \$1 per barrel on the price received by the company would result in plus or minus movement in the sales revenue of \$346,750 per annum.

### **Transactions with Related Parties**

Vazon Energy Limited ("Vazon") is a corporation organized under the laws of the Bailiwick of Guernsey, of which Dr. David Robson, Chief Executive Officer, is the sole owner and managing director. Tethys has a management services contract with Vazon that came into effect from June 27, 2007 whereby the services of Dr. Robson and other Vazon employees, as well as office services etc. are provided to the Company. The total cost charged to Tethys for services from Vazon in the six months ended June 30, 2009 was \$716,568 (2008 – \$634,577).

Oilfield Production Consultants (OPC) Limited and Oilfield Production Consultants (OPC) USA LLC, both of which have one common director with the company, has charged Tethys a monthly retainer fee for engineering expertise, provided services relating to the optimization of the existing compressors and those to be installed as part of Phase 2 gas production from Akkulka, and has consulted on certain reservoir modelling work on projects in Tajikistan. Total fees in the six months ended June 30, 2009 were US\$160,115 (2008 – \$Nil).

Transactions with affiliates or other related parties including management of affiliates are to be undertaken on the same basis as third party arms-length transactions.

### **Financial Instruments**

Financial assets and financial liabilities are recognised on the Company's statement of financial position when the Company becomes party to the contractual provisions of the instrument.

#### ***Trade receivables, loans and other receivables***

Trade receivables, loans and other receivables, which are non-derivative financial assets that have fixed or determinable payments that are not quoted in an active market, are classified as loans and receivables. They are included in current assets, except for maturities greater than 12 months after the reporting date, which are classified

as non-current assets. The Company's loans and receivables comprise trade and other receivables in the statement of financial position.

Loans and receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest rate method, net of any impairment.

A provision for impairment of trade receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments (more than 30 days overdue) are considered indicators that the trade receivable is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognised in the income statement. When a trade receivable is uncollectible, it is written off against the allowance account for trade receivables.

#### ***Cash and cash equivalents***

Cash and cash equivalents comprise cash in hand and current balances with banks and similar institutions which are readily convertible to cash. These are carried at fair value with gains or losses recognized through statement of comprehensive loss. Cash equivalents are short term deposits with a maturity of less than three months.

#### ***Derivative financial instruments***

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value. Changes in the fair value of derivative financial instruments are recognised immediately in the statement of comprehensive loss.

#### ***Interest bearing loans and borrowings***

All loans and borrowings are initially recognised at the fair value of the consideration received less directly attributable transaction costs. After initial recognition, interest bearing loans and borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses are recognised in the income statement when the liabilities are derecognised as well as through the amortisation process.

#### ***Trade payables***

Trade payables due are recognised on an accruals basis and are stated initially at fair value and subsequently measured at amortized cost using the effective interest method.

#### ***Equity instruments***

Equity instruments issued by the Company are recorded at the proceeds received net of direct issue costs.

#### ***Fair value***

The fair value of investments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the reporting date. For investments where there is no active market, fair value is determined using valuation techniques.

#### ***Revenue recognition***

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services in the ordinary course of the Company's activities. Revenue is shown net of royalties, value-added tax, returns, rebates and discounts and after eliminating sales within the Company.

Revenue is recognised when the amount can be reliably measured, it is probable that future economic benefits will flow to the entity, and when specific criteria have been met for each of the Company's activities as described below.

Revenues from crude oil and natural gas sales are recognised when the oil and gas has been lifted and the risk of loss transferred to a third-party purchaser. The Company uses the entitlement method to account for its revenue from sales of oil and gas production, whereby the Company recognises revenue based on its direct ownership interest in its underlying oil and gas properties.

Interest income is recognized on a time-proportion basis using the effective interest method.

#### ***Borrowing cost***

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying capital asset or project under construction are capitalised and added to the asset or project cost during construction until such time as the asset or project is substantially ready for its intended use. Where funds are specifically borrowed to finance an asset or project, the amount capitalised represents the actual amount of borrowing cost incurred. Where funds used to finance an asset or project form part of general borrowings, the amount capitalised is calculated by using a weighted average of rates applicable to relevant general borrowings of the Company during the period. All other borrowing costs are recognised in the income statement in the period in which they are incurred.

#### ***Taxation including deferred taxation***

The tax expense represents the sum of current tax payable and deferred tax. Current tax payable is based on the taxable profits for the year. The Company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the bases of assets and liabilities and their carrying amounts in the financial statements. However, the deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither the accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the reporting date and are expected to apply when the related deferred tax asset is realised or the deferred income tax liability settled. Deferred income tax assets are recognised to the extent that it is probable that the future taxable profit will be available against which the temporary differences can be utilised.

#### ***Share-based payment***

The Company operates an equity-settled, share-based compensation plans. The fair value of the employee services received in exchange for the grant of the options is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted. When options vest in instalments over the vesting period, each instalment is accounted for as a separate arrangement. At each reporting date, the entity revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity.

The proceeds received net of any directly attributable transaction costs are credited to share capital when the options are exercised.

#### ***Segment reporting***

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker has been identified as the Executive directors that make strategic decisions.

### **Critical Accounting Policies and Estimates**

The interim consolidated financial statements for the three months ended June 30, 2009 have been prepared in accordance with IAS 34 - Interim Financial Reporting and are in accordance with IFRS 1 - First-time Adoption of IFRS, as they are part of the period covered by the Company's first IFRS financial statements for the year ending December 31, 2009.

Please refer to the interim consolidated financial statements for the three months ended June 30, 2009 Note 3 *Summary of Significant Accounting Policies* for details of the Company's accounting policies and to Note 23 *Transition to IFRS* for the reconciliations of the changes resulting from this transition. See also *Changes to Accounting Policies* below.

A summary of the Company's significant accounting policies can be found in Note 3 to the interim consolidated financial statements for the three months ended June 30, 2009. The following is a discussion of those accounting policies and estimates that are considered critical in the determination of the Company's financial results.

#### ***Oil and gas exploration and evaluation expenditure***

Oil and natural gas exploration and evaluation expenditures are accounted for using a modified 'successful efforts' method of accounting. Costs are accumulated on a field-by-field basis. Exploration and evaluation expenditures, including license acquisition costs, are capitalised as exploration and evaluation assets when incurred. Expenditure directly associated with an exploration well is capitalised until the determination of reserves is evaluated. If reserves are not identified, these costs are charged to expense. All other associated exploration and evaluation expenditure are carried forward as an asset in the statement of financial position where the rights of tenure of the property are current and it is considered probable that the costs will be recouped through successful development of the property, or alternatively by its sale. Capitalised exploration and evaluation expenditure is written off where the above conditions are no longer satisfied.

If it is determined that commercial discovery has not been achieved in relation the property, all other associated costs are charged to expense. If commercial reserves are found, exploration and evaluation assets are tested for impairment and transferred to development tangible and intangible assets. No depreciation and/or amortisation is charged during the exploration and evaluation phase.

#### ***Oil and gas properties***

Oil and gas properties are stated at cost, less accumulated depreciation and accumulated impairment losses. Expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells, including unsuccessful development or delineation wells, is capitalised within oil and gas properties.

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the asset retirement obligation, and for qualifying assets, borrowing costs. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset. The capitalised value of a finance lease is also included within property, plant and equipment.

Where commercial production in an area of interest has commenced, oil and gas properties are depreciated on a unit-of-production basis over the proved and probable reserves of the field concerned, except in the case of assets whose useful life is shorter than the lifetime of the field, in which case the straight-line method is applied. Rights and concessions are depleted on the unit-of-production basis over the total proved and probable reserves of the relevant area. The unit-of-production rate for the amortisation of field development costs takes into account expenditures incurred to date, together with future development expenditure to develop the proved and probable reserves. Changes in factors such as estimates of proved and probable reserves that affect unit-of-production calculations do not give rise to prior year financial period adjustments and are dealt with on a prospective basis.

### ***Other property, plant and equipment***

Property, plant and equipment are carried at cost less accumulated depreciation. Depreciation is charged so as to write off the cost of these assets less residual value over their estimated useful economic lives, for the following classes of assets:

Drilling rigs and related oil and gas equipment	Unit of production 3,650 days operating days
Motor vehicles	Straight line 4 years
Computer equipment	Straight line 3 years
Office equipment	Straight line 5 years

### ***Reserve Estimates***

Reserve estimates can have a significant impact on net revenue and the carrying value of capital assets. The Company last engaged independent third party specialists in reserve engineering, McDaniel & Associates Consultants Ltd (“McDaniel”), to evaluate the recoverable reserves of all of the Company’s contracts in Kazakhstan as at December 31, 2008 in accordance with NI 51-101. The process of estimating reserves requires significant judgment based on available geological, geophysical, engineering, and economic data, projected rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to interpretation and uncertainty. Reserve estimates can impact net Revenue through depletion expense and the application of impairment tests. Revisions or changes in reserve estimates can have either a positive or a negative impact on net Revenue and can impact the carrying amount of capital assets.

### ***Business Combinations***

Business combinations are accounted for using the purchase method of accounting. The cost of an acquisition is measured as the cash paid and the fair value of other assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities acquired is recognized as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Goodwill represents the excess of the cost of an acquisition over the fair value of the group’s share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in ‘intangible assets’. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose identified according to operating segment.

### ***Intangible assets***

#### ***Production enhancement contracts***

Production enhancement contracts acquired in a business combination are recognised at fair value at the acquisition date. These contracts have a finite useful life and are carried at cost less accumulated amortization. Amortization is calculated using a unit-of-production basis over the proved and probable reserves of the field

### ***Production variances from Reported Reserves***

Potential lenders may also use reserve estimates to assess the allowable borrowing base under a secured credit facility. Changes to the reserve estimates can result in borrowing base increases or decreases, which could impact the Company's financial position. The Company currently has no debt under such arrangements.

### **Impairment of non-financial assets**

Exploration and evaluation costs are tested for impairment when reclassified to oil and gas properties or whenever facts and circumstances indicate potential impairment. An impairment loss is recognised for the amount by which the exploration and evaluation expenditure's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of the exploration and evaluation expenditure's fair value less costs to sell and their value in use.

Values of oil and gas properties and other property, plant and equipment are reviewed for impairment when indicators of such impairment exist. If any indication of impairment exists an estimate of the asset's recoverable amount is calculated. Individual assets are grouped for impairment assessment purposes at the lowest level at which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. An asset group's recoverable amount is the higher of its fair value less costs to sell and its value in use. Where the carrying amount of an asset group exceeds its recoverable amount, the asset group is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are adjusted for the risks specific to the asset group and are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money.

If the carrying amount of the asset exceeds its recoverable amount, the asset is impaired and an impairment loss is charged to the income statement so as to reduce the carrying amount to its recoverable amount (i.e. the higher of fair value less cost to sell and value in use).

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the Company makes an estimate of the recoverable amount. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years.

### **Provisions for other liabilities and charges**

#### ***General***

Provisions are recognised when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Company expects some or all of a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the income statement net of any reimbursement. The increase in the provision due to passage of time is recognized as interest expense

#### ***Asset retirement obligation (ARO)***

Provision is made for the present value of the future cost of abandonment of oil and gas wells and related facilities. This provision is recognised when a legal or constructive obligation arises. The estimated costs, based on engineering cost levels prevailing at the reporting date, are computed on the basis of the latest assumptions as to the scope and method of abandonment. Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate, updated at each reporting date that reflects current market

assessments of the time value of money and the risks specific to the obligation. The corresponding amount is capitalised as part of exploration and evaluation expenditure or oil and gas properties and is amortised on a unit-of-production basis as part of the depreciation, depletion and amortisation charge. Any adjustment arising from the reassessment of estimated cost of ARO is capitalised, whilst the charge arising from the accretion of the discount applied to the ARO is treated as a component of finance costs.

The Company recognises neither the deferred tax asset regarding the temporary difference on the ARO liability nor the corresponding deferred tax liability regarding the temporary difference on capitalized ARO cost.

#### ***Foreign currencies***

The interim consolidated financial statements are presented in US Dollars, which is the Company's functional and reporting currency. Transactions in foreign currencies are initially recorded at the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the reporting date. All differences are taken to profit or loss. Non monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined

#### ***Inventories***

Inventories consist of spare parts and consumable materials and are shown at the lower of cost or net realisable value. Cost is determined on a first-in-first-out method.

#### ***Investments***

Investments comprise restricted current balances that are held on deposit with banks in the Republic of Kazakhstan in respect of the Company's ARO in this country and are classified as non current. These are carried at fair value with gains or losses recognized through the statement of comprehensive loss.

### **CHANGES TO ACCOUNTING POLICIES**

The Accounting Standards Board ("AcSB") confirmed in February 2008 that International Financial Reporting Standards ("IFRS") will be used for Canadian publicly accountable enterprises for financial periods beginning on and after January 1, 2011 but as a foreign issuer, Tethys took the decision to do so for periods beginning January 1, 2009 and consequently has prepared its first financial statements in accordance with IFRS for the three month period ended June 30, 2009.

Please refer to Interim Consolidated Financial Statements as at June 30, 2009

#### ***Impact of adoption of IFRS***

These interim consolidated financial statements for the period ended June 30, 2009 are the Company's second financial statements prepared under IFRS. For all accounting periods prior to this, the Company prepared its financial statements under generally accepted accounting principles in the United States of America ('US GAAP'). In accordance with IFRS 1 'First time adoption of IFRS', certain disclosures relating to the transition to IFRS are given in this note. These disclosures are prepared under IFRS as set out in the basis of preparation in Note 2 to the Interim Consolidated Financial Statements as at June 30, 2009.

#### **Explanation of the effect of the transition to IFRS**

The interim consolidated financial statements for the period ended March 31, 2009 were the Company's first financial statements prepared under IFRS. For all accounting periods prior to this, the Company prepared its financial statements under generally accepted accounting principles in the United States of America ('US GAAP'). In accordance with IFRS 1 'First time adoption of IFRS', certain disclosures relating to the transition to IFRS are

given in note 23 of the interim consolidated financial statements, in addition to what was disclosed in the consolidated financial statements for the period ended March 31, 2009. These disclosures are prepared under IFRS as set out in the basis of preparation in note 23 to the interim consolidated financial statements for the period ended June 30, 2009.

**The following explains the material adjustments to the statement of financial position of the Company at January 1, 2008:**

**1 Explanation of the effect of the transition to IFRS**

The following explains the material adjustments to the statement of financial position of the Company.

	\$
(a) <b>Reclassification of cost from property, plant and equipment to intangible assets.</b> In accordance with IAS 16, IAS 38 and IFRS 6 the Company reallocated certain costs relating to unproved properties from property, plant and equipment to intangible assets.	7,661
<b>Expense pre licence expenditure.</b> On discontinuance of the policy of full cost accounting, expenditure incurred prior to the date on which the Company obtaining legal title to the relevant licences or concessions to explore and develop areas of interest, previously capitalised within the full cost pool, is written off.	(326)
<b>Net effect –increase in intangible assets</b>	<u>7,335</u>
(b) <b>Reclassification of cost from property plant and equipment to intangible assets.</b>	(7,661)
<b>Reverse impairment loss.</b> On transition to IFRS, a previous impairment loss recognised for Kazakhstan oil and gas properties in the year ended December 31, 2007 was reversed. US GAAP establishes a 'cost ceiling' for each cost center which limits the amount of costs that can be capitalized in each cost center. If a cost center's unamortized capitalized costs exceed the ceiling, the net capitalized costs must be written down to the ceiling. In calculating the ceiling limit under US GAAP, the present value of estimated future net revenues is computed by applying current prices of oil and gas reserves to estimated future production of proved oil and gas reserves, less estimated future expenditures to be incurred in developing and producing the proved reserves. The present value of estimated future net revenues is computed using a discount factor of 10% and assuming continuation of existing economic conditions. At the date of transition to IFRS, all CGUs were assessed for impairment by comparing the carrying value of the CGU to the recoverable amount. Recoverable amount was determined as value in use and was calculated as the present value of future cash flows expected to be derived from the CGU. The present value of future cash flows was computed on a pre-tax basis by applying forecast prices of oil and gas reserves to estimated future production of proved and probable oil and gas reserves, less estimated future expenditures to be incurred in developing and producing the proved and probable reserves. The present value of estimated future net revenues is computed using a discount factor of 5%.	12,800
<b>Expense unsuccessful exploration and evaluation cost.</b> On the discontinuance of full cost accounting, drilling expenditures associated with unsuccessful exploration wells drilled prior to December 31, 2007 were expensed. These costs were previously included in the carrying value of the full cost pool.	(3,799)
<b>Expense pre licence expenditure.</b> On discontinuance of the policy of full cost accounting, expenditure incurred prior to the date on which the Company obtaining legal title to the relevant licences or concessions to explore and develop areas of interest, which were	(907)

\$

previously capitalised within the full cost pool, is written off.

**Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation.** The discounted value of the future cash flows related to funding the Company's decommissioning liabilities in relation to oil and gas properties is increased due to a change in the discount rate applied from a risk adjusted rate as required by US GAAP to a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. This results in an addition to the carrying value of oil and gas properties. This increase in carrying value is depreciated over the remaining life of the relevant field in accordance with the Company's depreciation policy. 389

**Reduction in depletion of oil and gas properties.** Each producing field or concession is depreciated separately using the unit of production method based on proved and probable reserves. Under US GAAP depreciation was based on the countrywide full cost pool of all proved properties, both producing and non-producing, and calculated on the unit of production method over only the proved reserves. 33

**Net effect – increase in property, plant and equipment** 855

(c) **Adoption of IFRS 2.** The expense relating to employee options is recognised individually for each vesting tranche over the applicable vesting period, as opposed to on a straight line method over the total requisite service period as permitted by US GAAP. 646

**Effect - increase option reserve** 646

(d) **Increase in asset retirement provision.** The provision relating to the cost of future restoration cost of oil and gas properties increases in line with the increase noted in (b) above. 389

**Effect – increase in provisions for liabilities and charges.** 389

(e) The cumulative effect of these transition adjustments on the accumulated deficit as at January 1, 2008 is a decrease of: **7,155**

**The nature of adjustments from US GAAP to IFRS at June 30, 2009 is similar to those disclosed in the interim consolidated financial statements for the period ended March 31, 2009.**

\$

(a) Reclassification of cost from property, plant and equipment to intangible assets	9,359
Expense pre licence expenditure	<u>(601)</u>
Net effect – increase in intangible assets	<u>8,758</u>
(b) Reclassification of cost from property plant and equipment to intangible assets	(9,359)
Reverse impairment loss	12,800
Expense unsuccessful exploration cost	(3,799)
Expense pre licence expenditure	(906)

	\$
Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation.	438
Reduction of depletion of oil and gas properties	<u>1,097</u>
Net effect –increase in intangible assets	<u>271</u>
(c) Adoption of IFRS 2	1,278
Adoption of IAS 32	<u>(967)</u>
Net effect –increase in intangible assets	<u>311</u>
(d) Increase in asset retirement obligation. Effect – increase in provisions for liabilities and charges.	377
(e) Adoption of IAS 32. Effect – increase in current liabilities	839
(f) The cumulative effect of these transition adjustments on the accumulated deficit as at June 30, 2008 is an increase of:	7,502

**The nature of adjustments from US GAAP to IFRS at June 30, 2008 is similar to those at January 1, 2008 and June 30, 2008. There are two additional adjustments, both relating to intangible assets (see (a) below).**

	\$
(a) Reclassification of cost from property, plant and equipment to intangible assets	13,855
Expense pre licence expenditure	(715)
Expense unsuccessful exploration cost. On the discontinuance of full cost accounting, drilling expenditures associated with unsuccessful exploration wells drilled during the prior from January 1, 2008 to December 31, 2008 were expensed. These costs were previously included in the carrying value of the full cost pool.	(1,464)
Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation on exploration well drilled during the prior from January 1, 2008 to December 31, 2008 due to reduction in the discount rate as described in note 23.1 (b).	<u>12</u>
Net effect – increase in intangible assets	<u>11,688</u>
(b) Reclassification of cost from property plant and equipment to intangible assets	(13,855)
Reverse impairment loss	12,800
Expense unsuccessful exploration cost	(3,799)
Expense pre licence expenditure	(1,347)
Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation.	98
Reduction of depletion of oil and gas properties	<u>2,149</u>
Net effect –increase in intangible assets	<u>(3,954)</u>

	\$
(c) Adoption of IFRS 2	1,121
Adoption of IAS 32.	<u>(1,163)</u>
Net effect –increase in intangible assets	<u>( 42)</u>
(d) Increase in asset retirement obligation. Effect – increase in provisions for liabilities and charges.	32
(e) Adoption of IAS 32. Effect – increase in current liabilities	146
(f) The cumulative effect of these transition adjustments on the accumulated deficit as at June 30, 2008 is an increase of:	7,598

**The following explains the material adjustments to the statement of comprehensive loss of the Company for the three months ended June 30, 2008.**

	\$
(a) Reduction in the depletion expense for the period as a result of the transaction adjustment explained in note 23.1(b)	673
(b) Expense pre licence expenditure incurred during the period explained in note 23.1(a) and 23.1(b)	(274)
(c) Fair value gains on derivative financial instrument during the period explained in note 23.2(c)	122
(d) Increase in the cost of employee share options for the period as a result of the transition adjustment explained in note 23.1(c)	(376)
(e) Decrease in the accretion charge for the period on the Company’s asset retirement obligation due to the transaction adjustment in note 23.1 (b)	122

**The nature of adjustments from US GAAP to IFRS fro the six month ended June 30, 2008 is similar to those for the three month period ended on the same date.**

	\$
(a) Reduction in the depletion expense for the period	1,064
(b) Expense pre licence expenditure incurred during the period	(274)

(c)	Fair value gains on derivative financial instrument	141
(d)	Increase in the cost of employee share options for the period	<u>(645)</u>
(e)	Decrease in the accretion charge on the Company's asset retirement obligation	<u>61</u>

The following new and amended accounting standards are mandatory for the first time for the financial year beginning January 1, 2009:

- IAS 1 (revised), 'Presentation of financial statements'. The revised standard prohibits the presentation of items of income and expenses (that is 'non-owner changes in equity') in the statement of changes in equity, requiring 'non-owner changes in equity' to be presented separately from owner changes in equity. All 'non-owner changes in equity' are required to be shown in a performance statement. The Company has elected to present a single statement of comprehensive loss. The interim financial statements have been prepared under the revised disclosure requirements.
- IFRS 8, 'Operating segments'. IFRS 8 replaces IAS 14, 'Segment reporting'. It requires a 'management approach' under which segment information is presented on the same basis as that used for internal reporting purposes.
- IAS 23 (amendment), 'Borrowing costs' requires an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) as part of the cost of that asset. The option of immediately expensing those borrowing costs has been removed. This has no impact on the Company as its policy has always been to capitalise borrowing cost on qualifying assets.
- IFRS 2 (amendment), 'Share-based payment'. The amended standard deals with vesting conditions and cancellations. It clarifies that vesting conditions are service conditions and performance conditions only. Other features of a share-based payment are not vesting conditions. These features would need to be included in the grant date fair value for transactions with employees and others providing similar services; they would not impact the number of awards expected to vest or valuation thereof subsequent to grant date. All cancellations, whether by the entity or by other parties, should receive the same accounting treatment. The amended standard does not have a material impact on the Company's financial statements.

The following new standards, amendments to standards and interpretations are mandatory for the first time for the financial year beginning January 1, 2009, but are not currently relevant for the Company:

- IAS 32 (amendment), 'Financial Instruments: Presentation'.
- IFRIC 13, 'Customer loyalty programmes'.
- IFRIC 15, 'Agreements for the construction of real estate'.
- IFRIC 16, 'Hedges of a net investment in a foreign operation'.
- IAS 39 (amendment), 'Financial Instruments: Recognition and measurement'.

#### **Accounting Standards and Interpretations issued but not yet effective**

Certain Accounting Standards and Interpretations are in issue which are not required to be adopted until after 2009 and have not been early adopted by the Company. As at the date of these financial statements the following Standards and Interpretations, which have not been applied in these financial statements but may have an impact on the Company's accounting policies, were in issue but not yet effective. Management is assessing the impact of these new standards on the Company's accounting policies and the financial statements:

- IFRS 3 (revised), 'Business combinations' and consequential amendments to IAS 27, 'Consolidated and separate financial statements', IAS 28, 'Investments in associates' and IAS 31, 'Interests in joint ventures', effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after July 1, 2009. The Company does not have any investment in associates or joint ventures.

The revised standard continues to apply the acquisition method to business combinations, with some significant changes. For example, all payments to purchase a business are to be recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the statement of comprehensive loss. There is a choice on an acquisition-by-acquisition basis to measure the minority interest in the acquiree either at fair value or at the minority interest's proportionate share of the acquiree's net assets. All acquisition-related costs should be expensed. The Company will apply IFRS 3 (revised) to all business combinations from January 1, 2010.

- IFRIC 17, 'Distributions of non-cash assets to owners', effective for annual periods beginning on or after July 1, 2009.
- IFRIC 18, 'Transfers of assets from customers', effective for transfers of assets received on or after July 1, 2009.

#### **Accounting systems**

The Company makes use of Sun Systems accounting software package to meet its accounting requirements. This is a well established package which will enable the Company to meet all of the accounting requirements under IFRS.

#### **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

The Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of Tethys are responsible for establishing and maintaining internal control over financial reporting (ICFR) as that term is defined in National Instrument 52-109 – Certification of Disclosure in Annual and Interim Filings. The CEO and the CFO of Tethys are responsible for designing a system of internal controls over financial reporting, or causing them to be designed under their supervision, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with IFRS.

Management of Tethys has designed and implemented, under the supervision of its CEO and CFO, a system of internal controls over financial reporting as of June 30, 2009 which it believes is effective for a company of its size. Management of Tethys has not identified any material weaknesses relating to the design of the internal controls over financial reporting as at March 31, 2009. Even allowing for the transition to IFRS there were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2009 that has materially affected or that is reasonably likely to affect Tethys' internal controls over financial reporting. The Company's control system and procedures are reviewed periodically and adjusted or updated as necessary. In addition where any new or additional risks have been identified either by Company personnel or on advice from the Company's auditors, then the management of Tethys has put in place appropriate procedures to mitigate these risks.

Under the supervision of the CEO and the CFO, in 2008 Management conducted an evaluation of the effectiveness of internal control over financial reporting based on "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organisations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as at December 31, 2008. A similar exercise will be carried out in the course of 2009.

## **DISCLOSURE CONTROLS AND PROCEDURES**

The CEO and the CFO are responsible for establishing and maintaining disclosure controls and procedures (DC+P) as that term is defined in NI 52-109. Disclosure controls and procedures have been designed by the Tethys Management, under the supervision of the CEO and CFO, to ensure that information required to be disclosed by the Company is accumulated, recorded, processed and reported to the Company's management as appropriate to allow timely decisions regarding disclosure.

## **FORWARD-LOOKING STATEMENTS**

In the interest of providing Tethys' shareholders and potential investors with information regarding the Company and its subsidiaries, including management's assessment of Tethys' and its subsidiaries' future plans and operations, certain statements contained in this MD&A constitute forward-looking statements or information (collectively referred to herein as "forward-looking statements") within the meaning of the "safe harbour" provisions of applicable securities legislation. Forward-looking statements are typically identified by words such as "anticipate", "believe", "expect", "plan", "intend", "forecast", "target", "project" or similar words suggesting future outcomes or statements regarding an outlook. Forward looking statements in this MD&A include, but are not limited to, statements with respect to: the projected 2009 capital investments projections, and the potential source of funding therefore. Readers are cautioned not to place undue reliance on forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By their nature, forward-looking statements involve numerous assumptions, known and unknown risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and other forward-looking statements will not occur, which may cause the Company's actual performance and financial results in future periods to differ materially from any estimates or projections of future performance or results expressed or implied by such forward-looking statements. These risks, uncertainties and assumptions include, among other things: volatility of and assumptions regarding oil and gas prices; fluctuations in currency and interest rates; ability to successfully complete proposed equity financing; product supply and demand; market competition; ability to realize current market gas prices; risks inherent in the Company's and its subsidiaries' marketing operations, including credit risks; imprecision of reserve estimates and estimates of recoverable quantities of oil and natural gas and other sources not currently classified as proved; the Company's and its subsidiaries' ability to replace and expand oil and gas reserves; unexpected cost increases or technical difficulties in constructing pipeline or other facilities; unexpected delays in its drilling operations; delays in the delivery of its drilling rigs; unexpected difficulties in, transporting oil or natural gas; risks associated with technology; the Company's ability to generate sufficient cash flow from operations to meet its current and future obligations; the Company's ability to access external sources of debt and equity capital; the timing and the costs of well and pipeline construction; the Company's and its subsidiaries' ability to secure adequate product transportation; changes in royalty, tax, environmental and other laws or regulations or the interpretations of such laws or regulations; political and economic conditions in the countries in which the Company and its subsidiaries operate; the risk of international war, hostilities, civil insurrection and instability affecting countries in which the Company and its subsidiaries operate and terrorist threats; risks associated with existing and potential future lawsuits and regulatory actions made against the Company and its subsidiaries; and other risks and uncertainties described from time to time in the reports and filings made with securities regulatory authorities by Tethys.

With regard to forward looking information contained in this MD&A, the Company has made assumptions regarding, amongst other things, the continued existence and operation of existing pipelines; future prices for natural gas; future currency and exchange rates; the Company's ability to generate sufficient cash flow from operations and access to capital markets to meet its future obligations; the regulatory framework representing mineral extraction taxes, royalties, taxes and environmental matters in the countries in which the Company conducts its business; gas production levels; and the Company's ability to obtain qualified staff and equipment in a timely and cost effective manner to meet the Company's demands. Statements relating to "reserves" or "resources" or "resource potential" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described exist in the quantities predicted or estimated, and can be profitably produced in the future. Although Tethys believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. Readers are cautioned that the foregoing list of important factors is not exhaustive. Furthermore, the forward-looking statements contained in this MD&A are made as of the date of this MD&A, and except as required by law Tethys

does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

## **RISK FACTORS**

For full details of the risk factors please refer to the MD&A filed with the December 31, 2008 audited consolidated financial statements or to the Company's AIF.